INTEGRATED BORROWING STRATEGY

1 Purpose of report

1.1 The Council has ambitious plans to invest in large-scale capital schemes and the majority of these will apply borrowing powers to facilitate delivery. Most significantly the removal of the Government-imposed debt cap to the Housing Revenue Account (HRA) unlocks the full freedoms of the self-regulated Prudential Code provided borrowing plans pass tests for affordability, prudence and sustainability.

1.2 As part of the annual Treasury Management Strategy (TMS), authority is delegated to the Director of Finance and Resources (Section 151 Officer) for the operational execution of the Council's treasury management activity including its borrowing strategy. This report is intended to highlight in greater detail the underlying considerations that influence operational decisions on borrowing.

2 Background

2.1 Each year as part of the annual budget cycle, the Council sets out its programme of planned capital spending for the coming four years. Capital expenditure can be paid for either:

a) **at the time it is incurred** by operating within our means and spending only cash-backed resources such as;
- capital receipts (generated from the sale of assets);
- reserves (such as major repairs reserve, earmarked reserves etc);
- capital grants (such as single capital pot, new homes bonus, highways maintenance funding, schools conditional funding, disabled facilities grant etc);
- contributions from other parties (such as developers, local enterprise partnerships, tariff etc);
- contributions from revenue budgets;

b) **by borrowing money** we don't currently have to pay for the upfront cost then gradually repaying it back with interest from revenue budgets over time (usually over the assets useful life to reflect the consumption of economic value).

2.2 Careful consideration is given before committing to fund capital expenditure. Cash-backed resources can only be spent once and so must go towards delivering the core objectives of the Council whilst securing value-for-money. Assets can be sold to raise new cash-backed capital receipts but in doing so depletes the authority's asset-base, needs careful consideration of market conditions and takes time to realise. Borrowing money generally exposes the authority to long-term revenue budget financing commitments, debt is easy to get into but difficult to renegotiate should circumstances change, and costs more because of the interest charges levied so must be prudent and affordable.

3 Capital Financing Requirement

3.1 The Capital Financing Requirement (CFR) measures a vital component of the authority's capital strategy, that is the amount of capital spending that has not yet been financed. It effectively measures the authority's underlying need to borrow for a capital purpose, although this borrowing may not necessarily take place externally (more on this in Section 3).

3.2 The CFR increases when any new capital schemes enter the capital programme and reduces when resources are applied to finance this liability, with any financing shortfall representing a borrowing requirement yet to be paid for. But the CFR is not allowed to rise indefinitely. Capital assets generally depreciate over time as they are consumed in the delivery of services. The Council is not required to raise council tax to fund depreciation or revaluation/impairment losses on capital assets, but it is however required to make an annual contribution from revenue budgets towards the reduction in its overall borrowing requirement. This amount is calculated on a "prudent" basis in accordance with statutory guidance, usually linked to capital asset useful lives. The statutory element of this charge is referred to as Minimum Revenue Provision (MRP) and in addition the authority can make further payments to repay its borrowing liability sooner known as Voluntary Revenue Provision (VRP). In both instances, this charge is directly related to the CFR. Unlike MRP, VRP can be reversed later should circumstances change, which would effectively reinstate a borrowing requirement.

3.3 There is no statutory requirement to charge MRP against the HRA element of the CFR. This is because unlike the General Fund, depreciation charges are a real revenue cost to the HRA. The cash set aside to cover asset depreciation can be used to maintain those assets so they hold their value or may be applied as VRP to repay borrowing liability.

3.4 So MRP and VRP are the setting aside of funds for the eventual repayment of borrowing. But loans raised are not directly linked to particular capital projects and the structure of the authority's loan portfolio is a separate treasury management responsibility that takes into consideration overall net cash flows and resources. This means there may be timing differences between availability of funds to repay borrowing and loans falling due for principal repayment.

3.5 The Council is not allowed to borrow to support revenue expenditure and so must ensure that borrowing levels are prudent and that net external borrowing (gross borrowing less investments) is only undertaken for a capital purpose. Net borrowing should not therefore, except to cover in-year cash flow timing differences, exceed the CFR for current financial year plus the expected changes to the CFR over the subsequent two years. This allows the authority some flexibility to borrow in advance of its immediate capital needs in exceptional circumstances (like securing an affordable borrowing rate in a rising interest rate economy).

4 Funding the Capital Financing Requirement – Internal vs External Borrowing

4.1 So, we have an underlying need to borrow for a capital purpose - but how do we raise these funds?

4.2 Borrowing is broken down into two categories:

a) **external**; such as loans from HM Treasury's local authority lending facility the Public Works Loan Board or financial institutions like banks; or

b) **internal**; by borrowing from our cash-backed reserves and available working capital we already have in the bank.

4.3 To determine the most appropriate funding method, the Council needs to have a firm understanding of its cash-backed resources. The first port of call is to analyse the Council's annual Balance Sheet prepared as part of the Statement of Accounts. The Balance Sheet presents the net worth of the authority, so the value of its assets less its liabilities, but in doing this it includes both cash-backed usable and non-cash unusable reserves, so we need to separate these.

4.4 Cash reserves include the General Fund & HRA minimum balances, earmarked reserves, capital receipts, capital grants not yet spent, HRA major repairs allowance and provisions for specific liabilities.

4.5 In addition, through the normal course of operating the authority may have surplus cash available for investment known as working capital. Technically speaking working capital is defined as current assets minus current liabilities, so if the value of the current assets i.e. those that can be realised within the next 12 months, exceeds the value of the current liabilities i.e. those that are owed within the next 12 months, the authority has a working capital surplus. If not, the authority has a working capital deficit.

4.6 These cash reserves and working capital make up amounts available to invest. When the return on investments is less than the cost of external borrowing, it is much more cost effective to internally use these funds to pay the underlying need to borrow for a capital purpose rather than take on external debt. We may need to replenish these internally borrowed funds at some point, and this could be for a variety of reasons including:

a) we now need to use those internally borrowed funds for the original purpose they were set aside, i.e. to fund capital works or settle liabilities; and/or

b) our working capital position has deteriorated, and so we no longer have enough excess operating cash available to be used in this way; and/or

c) external borrowing rates are forecast to rise, in which case it makes long-term financial sense to secure a lower rate now; and/or

d) investment returns have risen above the cost of borrowing, and within constraints of proper security and liquidity, we can make generate a net contribution to revenue budgets.

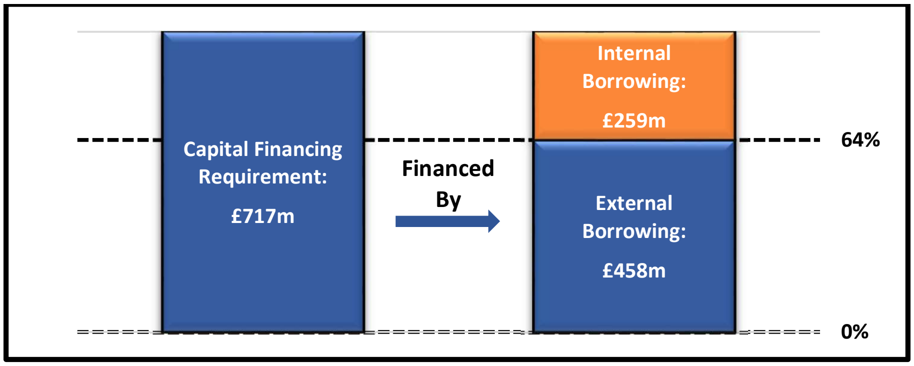
4.7 Consequently, by spending our surplus cash on our capital borrowing need we reduce our investment balances. Our investments are governed by strict criteria set out in our Treasury Management Strategy designed to limit risk, but nonetheless fewer investments mean further reduced exposure to the risk of counterparty failure.

4.8 Internal borrowing requires an active debt strategy. Rather than deciding at the beginning of the year how much we need to borrow and then automatically raising external loans during the year, we continue to spend our cash 'in-hand' and only exceptionally need borrow if we can strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over time.

5 Analysing Milton Keynes Council's position

5.1 At 31st March 2021, the Council's provisional outturn CFR stood at £717m. This has been financed by £458m of external borrowing and £259m of internal borrowing, as shown below:

Chart 1: CFR financing at 31/03/2021 provisional outturn



5.2 Based upon the existing capital programme and baseline HRA business plan model, the path of the CFR against the Council's existing external borrowing loans portfolio is shown in Chart 2(a-c) below:

Chart 2a: Combined Current CFR

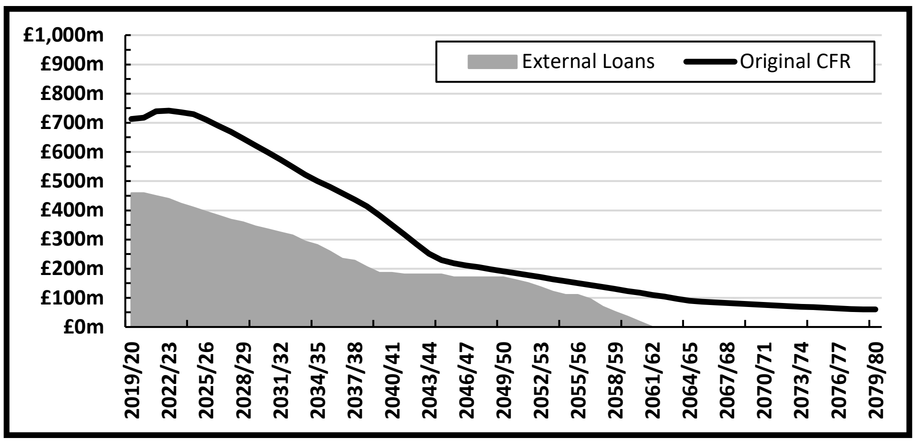


Chart 2b: General Fund Current CFR

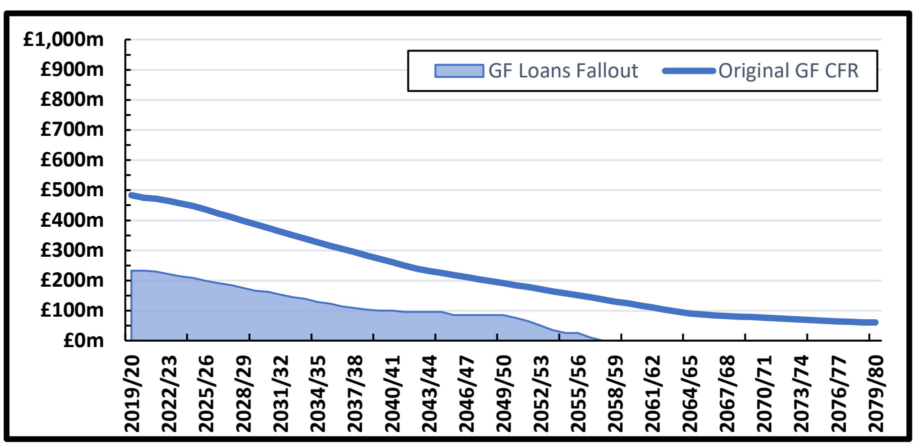
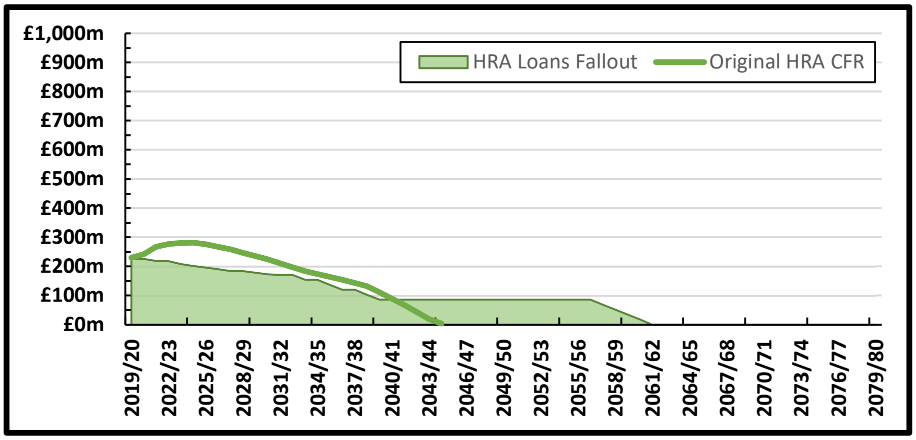
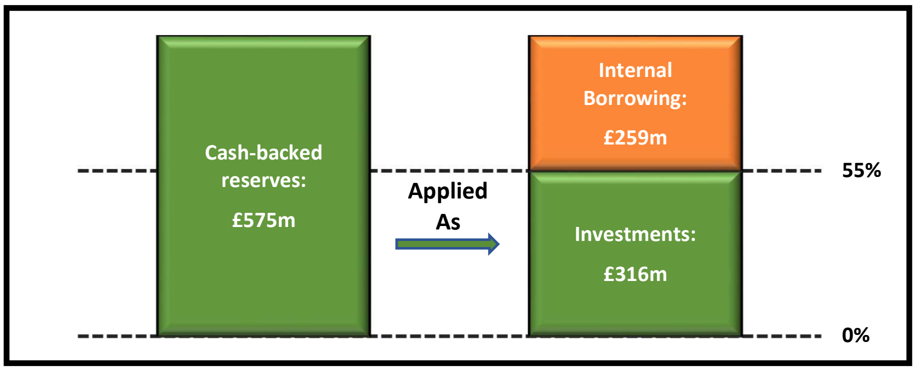


Chart 2c: HRA Current CFR



5.3 At 31st March 2021 (subject to audit), the Council's forecast cash-backed reserves stood at £396m and working capital surplus at £179m, which totals £575m. As stated in paragraph 4.1, £259m has been used as internal borrowing to fund the CFR in lieu of external borrowing, with the remaining £316m invested, as shown in Chart 3 below:

Chart 3: Cash-backed reserves at 31/03/2021 provisional outturn



5.4 Over the next seven years (2021/22 to 2027/28), there is forecast to be a £232.2m increase in the underlying need to borrow made up of:

- +£90.4m worth of external borrowing is maturing, and if not replaced this will add to the internal borrowing position.
- +£49.2m approved capital programme schemes financed by borrowing, which if not sourced externally will add to the internal borrowing position.
- -£118.0m of MRP and VRP will be set aside from new revenue resources not yet received, which will reduce the overall borrowing requirement and internal borrowing position.
- +£210.6m of proposed schemes funded by borrowing are under consideration but not yet approved, which if not funded externally, will add to the internal borrowing position. These are:
    - £84m HRA business plan investment scenarios modelling (Lakes phase A and Cripps Lodge);

- £36.6m on the Wolverton Agora project;
- £35m on acquisition of a Waste vehicle fleet;
- £20m on social care facilities
- £35m on various smaller schemes (prudent estimate of £5m per annum)

5.5 Taking these changes into account, the revised path of the Capital Financing Requirement is shown in Chart 4(a-c) below:

Chart 4a: Combined Revised Capital Financing Requirement

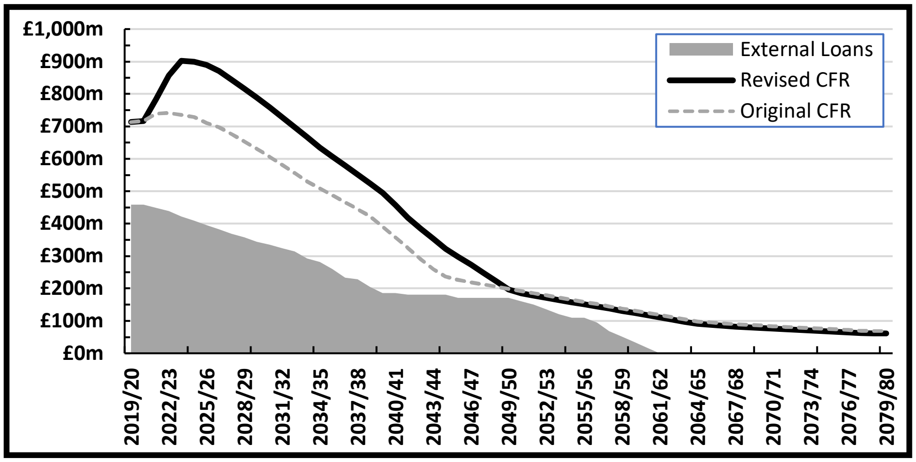


Chart 4b: General Fund Revised Capital Financing Requirement

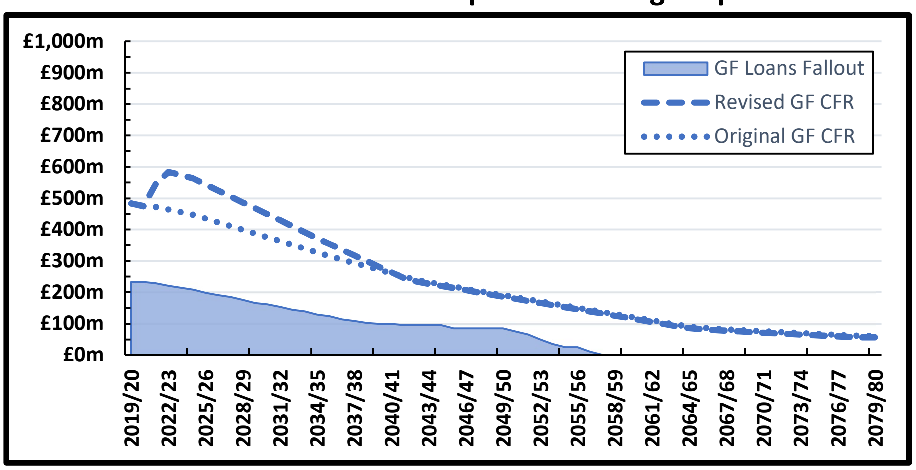
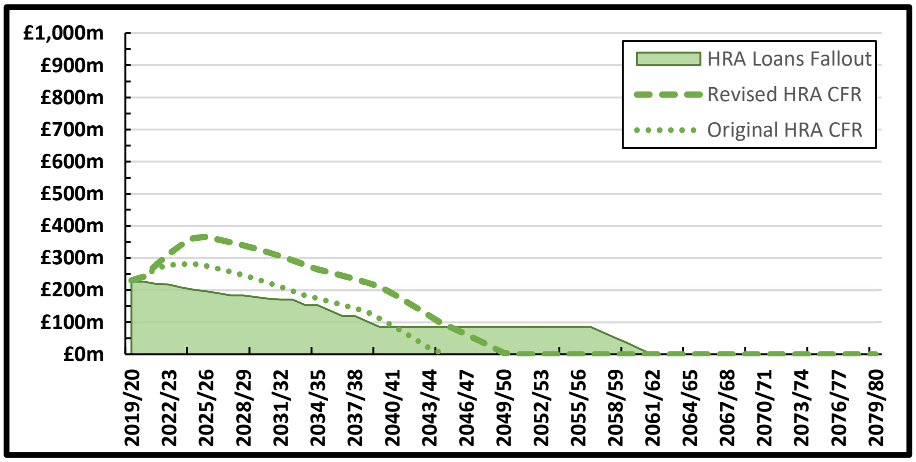


Chart 4c: HRA Revised Capital Financing Requirement



5.6 The Council is currently undertaking due diligence on a business case proposal put forward by Milton Keynes Development Partnership (MKDP) to establish a Local Housing Company (LHC) to delivery new affordable housing in Milton Keynes. This proposal would require raising net debt finance of £160m and should the Council choose to lend these funds at commercial rates, that would have a significant impact upon this borrowing strategy.

5.7 The primary risks to internal borrowing are:

- changes to the availability of cash-backed resources; this could range from earmarked reserves could be called upon sooner than expected, provisions depleted, our suppliers altering payment terms, our rise in non-payment of debts etc.
- interest rates; that rates rise at a time when external borrowing cannot be avoided.

5.8 To mitigate these risks requires careful ongoing monitoring of the Council's balance sheet position, good communication between service teams and treasury officers to forecast cash flow timings, and robust interest rate forecasts to anticipate sustained market increases.

5.9 Officers have assessed the composition of cash-backed resources to determine the risk associated with financing reliance upon them in Table 1 below.

Table 1: Risk analysis of cash-backed reserves, balances and provisions

Resource	2020/21 £m	2021/22 £m	2022/23 £m	2023/24 £m	RAG status	RAG commentary
GF Working Balance	30	29	29	29	G	Balance calculated based upon robust annual risk assessment as part of the budget setting process.
Funding Core Responsibilities	11	10	10	10	G	Reserves annually assessed as part of the budget setting process, no significant changes anticipated.
Managing High Volatility	22	27	15	10	A	By nature, high volatility services may be subject to change.
Delivering Transformation and Change	3	1	1	1	G	Reserves annually assessed as part of the budget setting process, no significant changes anticipated.
GF Temporary Earmarked Reserves	23	7	1	1	R	Expected to be applied to cover intended purpose.
Budget Management - Ring-fenced	7	6	7	8	G	Reserves annually assessed as part of the budget setting process, no significant changes anticipated.
Tariff Management	6	7	7	7	G	Reserves annually assessed as part of the budget setting process, no significant changes anticipated.
Delivering Capital Programme - GF	37	31	28	27	G	Reducing balance reflects approved capital programme. Changes may occur but will be controlled by governance process and any consequential impact on borrowing managed in an orderly manner.
3rd Party	11	8	1	1	R	Expected to be applied to cover intended purpose.
Covid19 S31 Grant Expanded Retail Relief Reserve	44	0	0	0	R	S31 grant relating to the rate reliefs that is applied in 2020/21 for business rates but we will not apply this funding until 2021/22 when the impact on the Collection Fund is charged to the General Fund.

Resource	2020/21 £m	2021/22 £m	2022/23 £m	2023/24 £m	RAG status	RAG commentary
Total General Fund Reserves	**194**	**126**	**99**	**94**		
HRA Working Balance	7	7	7	7	G	Balance calculated based upon robust annual risk assessment as part of the budget setting process.
Delivering Capital Programme - HRA	64	19	7	0	A	To applied to meet HRA Business Plan objectives. Risk relates to scale and ambition of spending plans when considered against historical capital slippage.
Total HRA Reserves	**71**	**26**	**14**	**7**		
Total Reserves	**265**	**152**	**113**	**101**		
Capital Grants Unapplied	52	50	50	50	A	Grants/contributions for which conditions met. Terms restrict how applied and/or the financial year in which this can take place. Government funding approach to bid for pots of resources, risk that we may not receive approval.
Capital Receipts Reserve	21	56	77	87	A	Includes gross forecast capital receipts from sale of Saxon Court, Western Area expansion and Tickford Fields. Delays would impact availability of cash-backed resources for internal borrowing.
Provisions	57	49	41	33	G	Most significant provisions are long-term for appeals on business rates valuations. Short-term provisions (such as insurance liabilities etc) expected to be reconfirmed on annual basis.
Working Capital Surplus	179	179	179	179	G	Ongoing surplus, sum of our current liabilities (what we owe) less our current assets (what we are owed). Annual review & analysis with TM advisors suggests this trend will continue.
Total Other	**309**	**334**	**347**	**349**		
Total Cash-backed Resources	**574**	**486**	**460**	**450**		

Resource	2020/21 £m	2021/22 £m	2022/23 £m	2023/24 £m	RAG status	RAG commentary
Total Red	78	15	2	2		
Total Amber	159	152	149	147		
Total Green	337	319	309	301		

5.10 In terms of the risk assessment above, the availability and volatility of these balances has been measured on the following basis:

- RED: cannot be relied upon for ongoing internal borrowing as they are highly likely to be spent soon.
- AMBER: can be relied upon for ongoing internal borrowing but require careful monitoring. Funds could be subject to change (around timing, amounts, government grant initiatives etc.) and possibly at short notice, which could force the Council into external borrowing even if market conditions are not ideal.
- GREEN: can be relied upon for ongoing internal borrowing. Primarily funds held for planned purposes and with controlled financial procedures on their application. Changes may occur but with advance planning, and so can be filtered naturally through to internal borrowing approach.

5.11 Over the next four years, overall cash-backed reserves being used for internal borrowing to suppress external borrowing are forecast to reduce by £124m. Added to the forecast £232.2m increase in the underlying need to borrow means a total funding requirement of £356.2m. Investments held at 31/03/2021 totalled £315m, and if the Council aimed to maintain a minimum investment level of £65m, this would leave a cash borrowing requirement of £106.2m. If risks materialise to those funds identified as amber in the assessment at Table 1 above, then that would directly add to the cash borrowing requirement.

6 Interest Rate Forecasts and Sensitivity

6.1 The timing and duration of any new external borrowing raised would be subject to the following primary factors:

- **Path of the CFR;** when borrowing for capital purposes, total borrowing should not typically exceed the CFR but follow its trajectory to allow for repayments in a timely manner. Borrowing decisions are not directly linked to the financing of capital schemes, which is a separate treasury management consideration taking into account available cash-backed resources, so loans do not necessarily need to mirror the lifecycle of assets.

- **Prevailing interest rates;** PWLB borrowing rates are set with reference to Government bond markets. Shorter loans are cheaper than longer dated loans due to the economic risks associated with time. In normal circumstances this risk premium does not grow exponentially but tails off in later years, creating what is known as a yield curve. This means that the Council could take a loan over a shorter duration at a cheaper rate, but if the borrowing requirement is not repaid, we may need to refinance that loan later at a time when interest rates may have risen (known as refinancing risk).

- **Maturity structure of existing loan portfolio;** Managing the debt maturity profile is essential for reducing exposure to large sums falling due for repayment within a short period, or refinancing when market conditions may not be most advantageous. Loans are relatively easy to secure but costly to restructure or pay back early should circumstances change.

6.2 The latest interest rate forecast from the Council's treasury management advisors (Link) is shown in Table 2 below. PWLB rates are based on interest-only loans with principal repaid on maturity and are shown inclusive of a 0.20% discount – known as the Certainty Rate – in return for providing HM Treasury with forward estimates of our capital programme and outline borrowing plans.

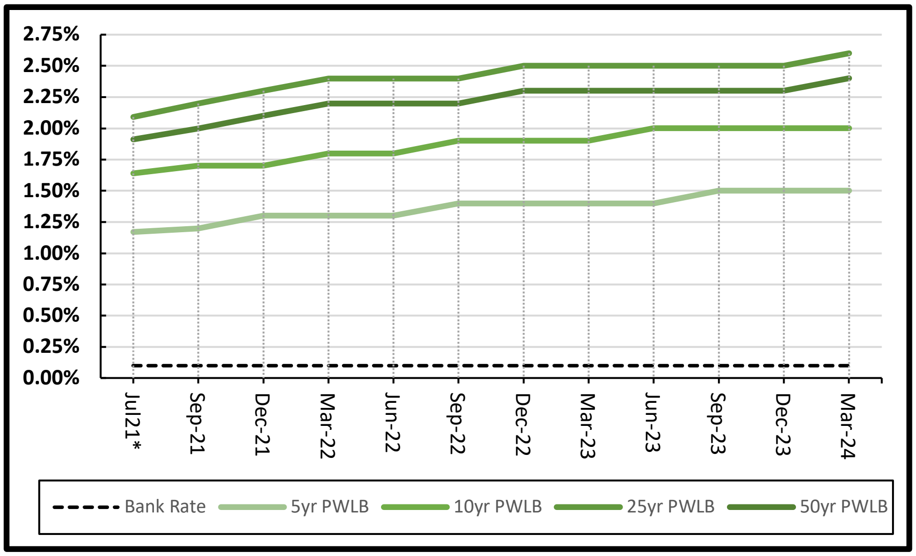
Table 2: Interest Rate Forecast

	Jul21*	Sep21	Dec21	Mar22	Jun22	Sep22	Dec22	Mar23	Jun23	Sep23	Dec23	Mar24
Bank Rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%
5yr PWLB	1.17%	1.20%	1.30%	1.30%	1.30%	1.40%	1.40%	1.40%	1.40%	1.50%	1.50%	1.50%
10yr PWLB	1.64%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	1.90%	2.00%	2.00%	2.00%	2.00%
25yr PWLB	2.09%	2.20%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB	1.91%	2.00%	2.10%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%

* Actual PWLB rates at 01/07/2021 (pm).

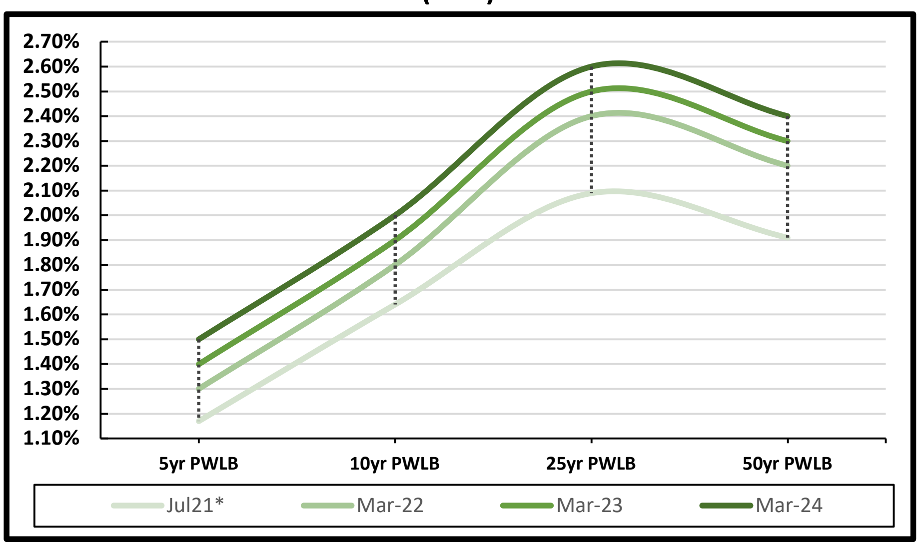
6.3 Chart 5 below plots this forecast, showing gradual stepped 0.10% increases over the next 3 years:

Chart 5: Interest Rate Forecast (Link)



6.4 Chart 6 below plots the yield curve concept (discussed in paragraph 6.1, bullet point 2) of this forecast:

Chart 6: Interest Rate Forecast (Link) – Yield Curve



6.5 Caution must always be exercised in relying upon interest rate forecasts, but this is particularly prevalent with so many volatile and variable factors influencing the economy at this time. The general expectation is for a trend of gently rising gilt yields, but negative (or positive) developments could significantly impact safe haven flows of investor money to Government bonds and produce shorter-term spikes from the central forecast.

6.6 It is also considered unlikely that the Bank of England will increase Bank Rate during the current and next two financial years, as inflation is not expected to return to being sustainably above the 2% target during this period.

7 Conclusion

7.1 The Director of Finance and Resources intends to fund the bulk of the Council's existing and new underlying capital debt liability by internal borrowing in 2021/22 before raising any new external borrowing in 2022/23 and 2023/24, subject to delivery of the capital programme and an ongoing assessment of cash-backed resources. This approach is supported by our Treasury Management advisors (Link) and is in line with impending (expected December 2021) changes to the Prudential Code which will introduce a net liability benchmark (deducting investments from borrowing outstanding) as a treasury management indicator to show the lowest level of debt the Council could hold if it applied available balances, reserves and cash flow surpluses as internal borrowing.

7.2 Given the significant sums and risks involved, this approach will be subject to vigorous ongoing monitoring as part of the Council's treasury management operations.

7.3 The most likely scenarios that would trigger a possible change in approach might be risks materialising on availability of cash-backed resources for internal borrowing or long-term external borrowing rates rising in a sharp & sustained manner.

7.4 Under a two-pool approach to attributing borrowing costs to either the HRA or General Fund, the HRA is expected to be virtually fully funded to its Capital Financing Requirement (CFR) where possible. Most of the cash-backed reserves that we hold are held for General Fund purposes. By adopting an internal borrowing strategy, the HRA's borrowing requirement will be funded by internal loans from the General Fund. This will generate for the General Fund a return on its cash resources above that it could achieve in traditional treasury management investments in the current economic climate as well as reduce exposure to credit risk. These loans will be based upon the lending terms and priced at PWLB-equivalent loan rates. A margin may be applied to reflect the transfer of external financing and interest rate risk to the General Fund, where appropriate.

7.5 The latest Medium Term Financial Plan includes an assumption that the HRA will borrow £80.0m in 2022/23 internally from the General Fund at 2.00% (set with reference to the interest rate forecast in Table 2 above), the net interest benefit to the General Fund in 2022/23 and 2023/24 is £1.4m split equally. This assumption is based on the latest HRA Business Plan estimated borrowing requirement including recently approved schemes (including the Lakes phase A and Cripps Lodge), with loans anticipated for repayment in tranches over between 7 to 17 years in line with Business Plan expectations of HRA surplus funds available to meet repayments.

7.6 Treasury Management update reports are presented to Cabinet on a quarterly basis. Where possible the Director of Finance and Resources intends to report any intention to raising new external borrowing before undertaking it, or where this cannot be achieved, brief the Cabinet member responsible for Resources and Innovation.